

$$\begin{aligned}
 R(t) \sum_{i=1}^I \frac{p_i(t) q_i(t)}{R(t)} \frac{\dot{q}_i(t)}{q_i(t)} + \frac{\dot{p}_i(t)}{p_i(t)} \frac{p_i(t) q_i(t)}{R(t)} &\equiv C(t) \sum_{i=1}^I \frac{C_i(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t) q_i(t)}{C(t)} \frac{\dot{q}_i(t)}{q_i(t)} \\
 &+ C(t) \sum_{j=1}^J \frac{C_j(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t) w_j(t)}{C(t)} \frac{\dot{w}_j(t)}{w_j(t)} \\
 &+ C(t) \frac{C_t(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t)}{C(t)}
 \end{aligned}$$

$$\begin{aligned}
 \sum_{i=1}^I \frac{\dot{p}_i(t)}{p_i(t)} \frac{p_i(t) q_i(t)}{R(t)} &\equiv - \sum_{i=1}^I \frac{(p_i(t) - C_i(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t)) q_i(t)}{R(t)} \frac{\dot{q}_i(t)}{q_i(t)} \\
 &+ \frac{C(t)}{R(t)} \sum_{j=1}^J \frac{C_j(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t) w_j(t)}{C(t)} \frac{\dot{w}_j(t)}{w_j(t)} \\
 &+ \frac{C(t)}{R(t)} \frac{C_t(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t)}{C(t)}
 \end{aligned}$$

Under competition,

$$p_i(t) = C_i(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t) \text{ and } R(t) = C(t) \text{ so}$$

$$\sum_{i=1}^I \rho_i(t) \frac{\dot{p}_i(t)}{p_i(t)} \equiv \sum_{j=1}^J \sigma_j \frac{\dot{w}_j(t)}{w_j(t)} + \frac{C_t(q_1(t), \dots, q_I(t), w_1(t), \dots, w_J(t), t)}{C(t)}$$

which can be shown to be

$$\sum_{i=1}^I \rho_i(t) \frac{\dot{p}_i(t)}{p_i(t)} \equiv \sum_{j=1}^J \sigma_j \frac{\dot{w}_j(t)}{w_j(t)} - \frac{\dot{TFP}}{TFP}.$$

To see this, note that if $F(y, x, t)$ is a distance function representing a technology, then the efficient netput pairs (y, x) satisfy $F(y, x, t) = 1$. Thus $F(y, x, t) \equiv 1$. Totally differentiating gives:

$$\frac{\partial F(y, x, t)}{\partial y} \dot{y} + \frac{\partial F(y, x, t)}{\partial x} \dot{x} + \frac{\partial F(y, x, t)}{\partial t} \equiv 0$$

$$\frac{\partial F(y, x, t)}{\partial t} \equiv - \left(\frac{\partial F(y, x, t)}{\partial y} \dot{y} + \frac{\partial F(y, x, t)}{\partial x} \dot{x} \right).$$

Also, by the envelope theorem, if

$$C(y, w, t) = \min \{x' w \mid F(y, x, t) = 0\}$$

then

$$\frac{\partial C(y, w, t)}{\partial t} = \lambda \frac{\partial F(y, x, t)}{\partial t}.$$

Whereas profit maximization implies:

$$p_i = \lambda \frac{\partial F(y, x, t)}{\partial y_i}$$

$$w_j = \lambda \frac{\partial F(y, x, t)}{\partial x_j}.$$

$$\begin{aligned} \frac{\partial C(y, w, t)}{\partial t} \frac{1}{C} &= - \frac{(p' \dot{y} + w' \dot{x})}{C} \\ &= - \frac{R}{C} \sum_{i=1}^I \frac{p_i y_i}{R} \frac{\dot{y}_i}{y_i} + \sum_{j=1}^J \frac{w_j x_j}{C} \frac{\dot{x}_j}{x_j} \\ &= - \frac{R}{C} \sum_{i=1}^I \rho_i \frac{\dot{y}_i}{y_i} + \sum_{j=1}^J \sigma_j \frac{\dot{x}_j}{x_j} \\ &= - \frac{\dot{\text{TFP}}}{\text{TFP}} \end{aligned}$$

Where $\frac{R}{C} = 1$, on account of the zero profit condition.

APPENDIX B

ARIMA FORECASTS PROVIDE THE BEST WAY OF DETERMINING A PCI ADJUSTMENT FACTOR ON A GOING-FORWARD BASIS THAT IS CONSISTENT WITH MIMICKING COMPETITION.

In this section, I will briefly outline an ARIMA forecasting method which could be used to predict the PCI on a going forward basis — the one-year ahead forecast based on the most up-to-date data set being used as the PCI adjustment factor.

Let y_t $t=0, \dots, T-1$ be an observed series of PCI adjustments. These are not the ones predicted by the Commission and imposed as the PCI adjustment factor. Rather, these are the PCI adjustments actually observed as calculated using the LEC direct method based on industry data.

Treating these as data, they are analyzed using ARIMA time series methods. That is, the data are investigated to see if there are trends or unit roots. If so, the data are differenced up to the degree of integration. It is unlikely that the PCI series will exhibit unit roots, so I discuss only the more standard stationary case. Let us assume that:

$$y_t - \mu = \sum_{i=1}^p \alpha_i (y_{t-i} - \mu) + \sum_{j=0}^q \theta_j \varepsilon_{t-j}$$

where the ε are white noise errors. The parameters p and q , representing the number of lags in the autoregressive part and in the moving average parts respectively, are values determined in an identification phase by examining the direct, inverse, and partial autocorrelation functions. The μ , α and θ are unknown parameters whose values are to be determined in the estimation phase. The support for this assumption is based on the fact that most time series can be represented this way. Those that cannot are rare and easily fixed. All the estimation,

identification and forecasting can be performed on a personal computer using off-the-shelf statistical software such as SAS Institute's PROC ARIMA.

Once the μ , α and θ are estimated, the forecast is made using the p most recent values of the y 's and the q most recent values of the ε which are fit as part of the forecasting process. Again this is an automatic procedure in most off-the-shelf statistical software.

For the PCI adjustment factor, the Commission has two choices. The first is to use the one-period ahead forecasts as discussed. The second would be to ignore any short term variation and to use the long-run equilibrium value of the PCI process. The long-run equilibrium value of this growth is simply μ . I recommend that the one-period ahead forecast be used.

Presumably, these calculations, as well as the forecasts, would be performed by qualified outside analysts. However, the LECs, as well as the Commission staff, can do the calculations themselves to aid in longer term decision making; *e.g.*, forecast for more than one-year if need be. The first year forecast should be used as the PCI adjustment factor; forecasts for subsequent years can be used as estimates for planning purposes.

APPENDIX C

THE MCI PRICE CONTROL PROPOSAL WILL LEAD TO SHORTAGES

Assume the following:

- The eventual equilibrium price will be p_e and this is at marginal cost or TELRIC;
- The current price, p_r , is higher than p_e .
- In a misguided attempt to get the price down to the eventual equilibrium price as quickly as possible to deliver the benefits of competition to the ratepayers, a price cap at the eventual equilibrium price is imposed.

The situation is illustrated in Figure 1 using simple demand and cost curves for the incumbent firm that is assumed to be price taking in a price-cap environment.

Ordinarily with a current price p_c and costs given by p_e the incumbent firms earn economic profits by producing a level of output q_c . MCI can be viewed as a customer who wants the price to be set immediately to p_e . The problem is that in setting the price to its equilibrium position, no firm will enter the market, so that at the new price the output will stay at q_c . The pair (p_e, q_c) represents not an equilibrium but a disequilibrium with a shortage given by $q_e - q_c$. In such a circumstance, demand exceeds supply and shortages develop. In the end, the difference is rationed according to non-price.

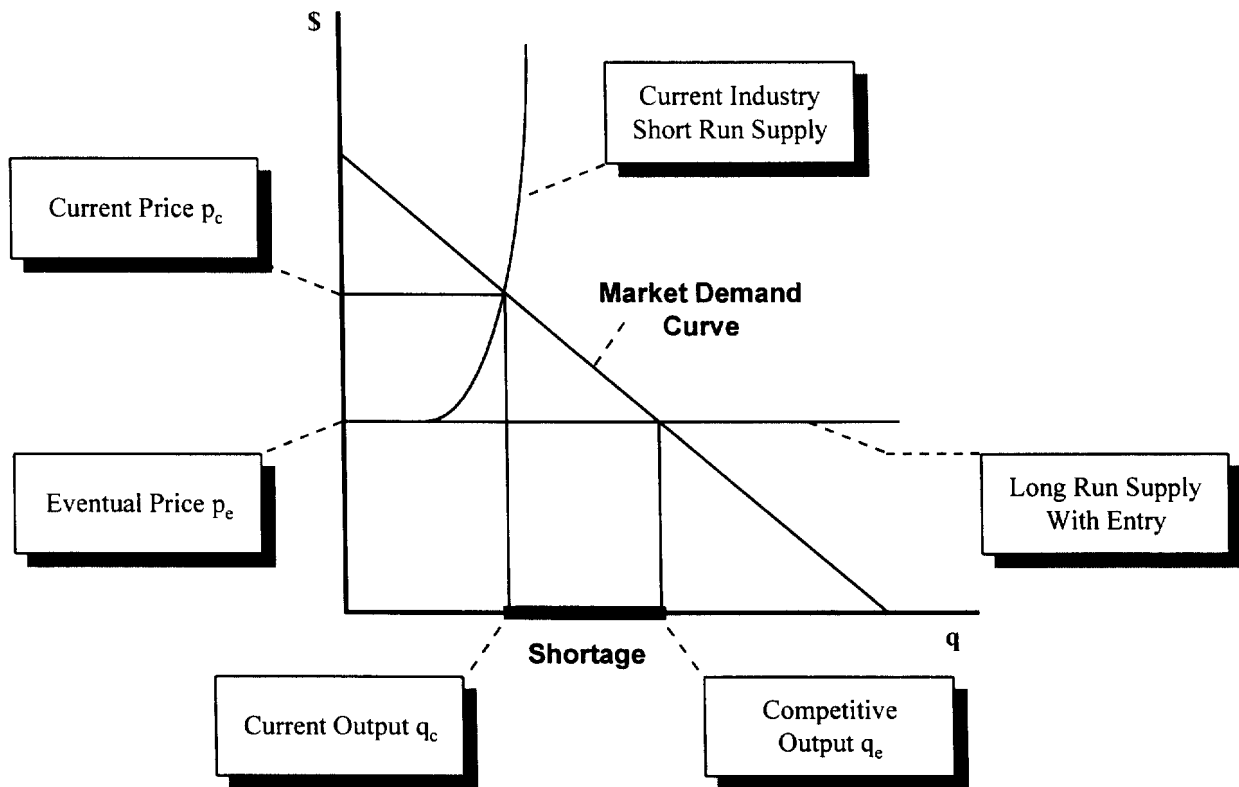
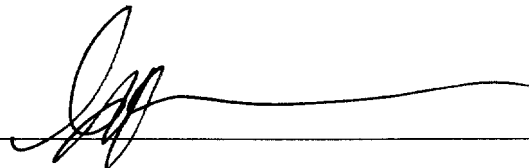


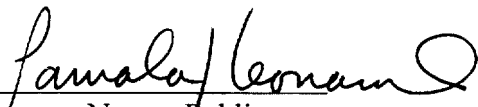
Figure 1

The affiant says nothing further.

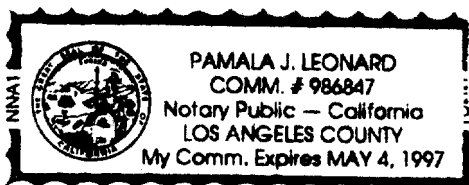


Gregory M. Duncan

Subscribed and sworn to
before me this 14th day of
February, 1996.



Notary Public



APPENDIX C

**Summary of Access Competition
GTE**

		Existing	Pending	Total	DS1 Equivalents 2/	
Arkansas	1	1	0	1	4	
California	7	8	13	21	1848	2088
Florida	6	7	6	13	1176	432
Hawaii	2	4	6	10	532	
Illinois	2	4	0	4	420	
Kentucky	2	1	1	2	0	
Missouri	2	5	1	6	491	
North Carolina	3	4	0	4	631	
Ohio	1	1	0	1	0	
Oklahoma	1	1	0	1	336	
Texas	3	2	1	3	420	1476
Pennsylvania	1	1	0	1	308	
Texas	5	4	22	26	2196	
Washington	3	3	2	5	224	300
Total GTE	19	46	52	98	8586	4296

1/ Number of competitive providers in each state. Providers operating in more than one state are shown only once in total.

2/ Number of cross-connects at DS3 and DS1 level on DS1 equivalent basis.

3/ Number of cross-connects at VoiceGrade/DS0 level for access to line side of switch or loops.

APPENDIX D

Pricing Flexibility in Exchange Access Reform

Michael A. Salinger
February, 1997

Pricing Flexibility in Exchange Access Reform

Table of Contents

I. INTRODUCTION	1
II. THE OBJECTIVES OF ACCESS REFORM	4
A. BACKGROUND	4
B. FOUR LEGITIMATE OBJECTIVES	5
C. PROTECTING COMPETITORS IS NOT AN OBJECTIVE.....	6
III. THE NATURE OF THE “MARKET-BASED” APPROACH	7
A. AN ALTERNATIVE PERSPECTIVE.....	7
B. RELATIVE ADVANTAGES OF REGULATING INPUT (UNBUNDLED ELEMENT) VS. OUTPUT (SERVICE) PRICES IN GENERAL.....	8
C. RESERVATIONS ABOUT THE MARKET-BASED APPROACH IN ACCESS REFORM	9
D. SAFEGUARDS	11
IV. ADVANTAGES OF PRICING FLEXIBILITY	11
A. GENERAL PRESUMPTION THAT CONTRACTING PARTIES SHOULD BE ALLOWED MUTUALLY AGREEABLE TERMS	12
B. NEED FOR IMMEDIATE AND GENERAL PRICING FLEXIBILITY TO MEET COMPETITION.....	12
C. BENEFITS FROM OTHER FORMS OF FLEXIBILITY	13
1. <i>Quantity Discounts</i>	13
2. <i>Incentives for Demand Increases</i>	15
3. <i>Peak-load Pricing</i>	15
4. <i>Term Discounts</i>	15

V. THE RESERVATIONS ABOUT PRICING FLEXIBILITY - HOW IMPORTANT ARE THEY?	16
A. RELATIONSHIP BETWEEN GEOGRAPHIC DEAVERAGING AND PRICE CAPS.....	16
1. <i>The Concern</i>	16
2. <i>Need for Immediate Geographic Deaveraging</i>	17
B. TWO-PART TARIFFS	19
1. <i>Concern 1: Sharing the Gains from Monopolization</i>	19
2. <i>Why Concern 1 is Not Serious in the Market for Exchange Access</i>	20
3. <i>Concern 2: Raising Rivals' Costs</i>	21
4. <i>Why Concern 2 is not Serious in the Market for Exchange Access</i>	21
VI. CONCLUSION	22

I. INTRODUCTION

In its Notice of Proposed Rulemaking on exchange access reform,¹ the Federal Communications Commission (FCC) outlines what it describes as two alternative approaches to access reform. In one, which it labels “market based,” the FCC proposes three stages of deregulation associated with three stages of competition labeled “potential competition,” “actual competition,” and “full competition.” Under this proposal, an incumbent local exchange carrier (ILEC) is to be given various types of pricing flexibility once it meets a checklist of conditions that the FCC suggests is necessary for potential competition. The existence of “actual competition,” as defined by the FCC, will trigger various reforms of price cap regulation. Finally, full competition will result in the end of price regulation on the ILEC altogether. The discussion in the NPRM of the “prescriptive” approach focuses mainly on ways of lowering the regulated price of access rates, although it does acknowledge that the rate structure must change as well. With regard to the “market based” approach, the FCC seeks comments on the specific criteria for judging whether the ILEC is subject to potential and actual competition.² It also “invite(s) comments on this general approach to access reform” and

¹ *In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Structure and Pricing, and Usage of the Public Switched Network by Information Service and Internet Access Providers*, CC Dockets 96-262, 94-1, 91-213, and 96-263, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, 1996 (NPRM and Interconnection Order).

² NPRM, ¶ 163.

on “whether these or other regulatory reforms should be implemented without the achievement of any competitive benchmarks, or upon the achievement of benchmarks different from those proposed.”³

I have been asked by GTE to assess the general approach that the FCC proposes for access reform and to analyze what conditions, if any, should be required before granting the ILECs pricing flexibility in the exchange access market. In light of basic economic principles about the nature of the competitive process, the extreme distortions in exchange access regulation that were implemented under dramatically different competitive circumstances and are now untenable, and an economic approach to understanding the regulatory process itself,⁴ I have arrived at the following conclusions:

1. What the FCC calls a “market based” approach is not truly market-based. Rather, it represents the substitution of one level of regulation (the price of unbundled elements) for another (the price of service); and in the interim it entails two levels of potentially inconsistent regulations.
2. In pursuing access reform, the FCC should weigh four related objectives: prices at competitive levels, economically efficient rate structures, recovery of the cost of the local exchange, and efficient competitive outcomes. An outcome in which the

³ NPRM, ¶ 165.

⁴ By an “economic approach to the regulatory process,” I mean a perspective in which it is assumed that economic agents expend resources to use the legal and regulatory process to further their economic interests. See, George J. Stigler, “The Theory of Economic Regulation,” *Bell Journal of Economics and Management Science*, vol. 2, 1971, pp. 3-21,

ILECs cannot reasonably recover their cost of service is not sustainable. Failure to consider cost recovery in exchange access will necessarily require higher prices for local exchange service and/or higher universal service subsidies. Allowing inefficient competitive outcomes ultimately raises the total cost of providing telephone service and therefore results in higher prices. Efficient pricing structures result in efficient usage of telephone networks and generally contribute to the goal of providing for cost recovery.

3. Actual competition in exchange access already exists in many areas and the availability of unbundled elements creates additional competition. If ILECs are denied general pricing flexibility, then competitive outcomes will be inefficient and, in turn, prices for telephone service will necessarily be higher.
4. It is likely that there are geographic areas where the price of access (or, more accurately, the combined price of access and local exchange service) is below the cost of providing the service. The regulatory problem then becomes how to allow increases up to, but not above, rates that would prevail in a contestable market. Regulation of unbundled element prices, regulation of service prices, or a combination of the two are possible solutions. Whatever approach is taken, immediate geographic deaveraging is necessary. Any delays will prolong inefficiencies from subsidized rates and fail to provide the ILECs with a reasonable chance of earning an adequate return.

5. In choosing its approach, the FCC cannot be naive about the potential for competitors to use regulatory and legal actions as competitive tools. Any condition that the FCC imposes on the freedom of ILEC's to behave in a competitive manner can be expected to be used by competitors to protect themselves from competition.

II. THE OBJECTIVES OF ACCESS REFORM

A. Background

As the FCC's NPRM explains and as is generally well-known, the existing access pricing regime was designed to help cover the cost of the local exchange and thereby keep the price of local service low. It failed to meet this objective because it entailed uneconomic pricing structures that provided incentives to bypass the local exchange for the provision of exchange access to large customers. In the competition for exchange access, regulatory constraints on the ILECs prevented them from taking actions that would generally be available to firms in a competitive market. The FCC has recently granted some flexibility to deaverage rates for special access and switched access transport in areas where they face competition, but the ILECs have not been given the amount of geographic pricing flexibility that would be available to firms in a truly competitive market. They have not been able to offer selective price cuts, quantity discounts, or long-term contracts, or to alter the mix of fixed and usage-sensitive charges that reflect the way costs are incurred. In short, they have not been able to take actions that would be associated with any reasonable definition of what it means "to compete." As a result, there is no reliable way to know whether competing providers of

exchange access have succeeded by outperforming the ILECs (i.e., being more efficient or providing better or at least differentiated service) or whether their survival is simply due to the protection of a regulatory umbrella.

B. Four Legitimate Objectives

The FCC is now in the position of reforming access pricing in conjunction with its efforts to open up local exchange service to competition⁵ and to provide for universal service.⁶ In choosing how to reform access regulation, it should consider four objectives. The first is, of course, to prevent excessively high pricing particularly in areas where competition is unlikely to arise. The second is to provide for efficient competition in which the firm that supplies exchange access between an interexchange carrier (IXC) and an end user is the one that can do so at the lowest effective cost. Inefficient competitive outcomes raise the total cost of providing telephone service and these costs generally result in higher prices. The third is to allow for a rational pricing structure that results in the most efficient usage of telecommunications networks.⁷ The fourth objective is to provide the ILECs a reasonable prospect for covering their total costs, including those costs usually treated as joint and

⁵ *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499, 1996 (Interconnection Order); *Order on Reconsideration*, CC Docket No. 96-98, 11 FCC Rcd 13402, 1996 (Interconnection Reconsideration Order); *Petition for Review Pending and Partial Stay Granted, sub nom. Iowa Utilities Board et. al v. FCC*, No. 96-3321 and consolidated cases, 8th Cir., October 15, 1996; *Partial Stay Lifted in Part, Iowa Utilities Board et. al v. FCC*, No. 96-3321 and consolidated cases, 8th Cir., November 1, 1996.

⁶ *Federal-State Joint Board on Universal Service*, Notice of Proposed Rulemaking and Order Establishing Joint Board, CC Docket No. 96-45, FCC 96-93 (rel. Mar. 8, 1996).

common. Ultimately, regulators cannot expect companies to provide telephone service if they are not able to recover the cost of doing so.

This last objective requires some elaboration. Whether or not the ILECs are entitled to the recovery of their embedded costs has not been settled. This objective remains even if the decision is made to deny the ILECs this recovery. They must at the very least be able to cover their forward-looking marginal costs as well as their forward-looking joint and common costs. This objective might seem inconsistent with the objective of having efficient competitive outcomes. While some conflict might be present, regulators do not have to guarantee the ILEC an adequate return. They do, however, have to establish “rules of the game” so that the ILEC has a reasonable chance to make an adequate return if it is efficient. Moreover, just as cars should not be required to have the fuel efficiency possible in a frictionless world, the standard for efficiency cannot be some idealized notion of the efficiency that would arise if management were a costless activity. Rather, the standard should be levels of efficiency that are attained in practice by firms in competitive markets.

C. Protecting Competitors is Not an Objective

Just as it is important to understand what the legitimate goals of the FCC are, it is equally important to understand what they are not. In particular, in pursuing access reform and any transition to access reform that is necessary, the FCC should have no inherent interest in

(...continued)

⁷ The FCC recognizes this objective as well. See NPRM, ¶13.

promoting entry or jump-starting competition that is independent of its interest in providing for efficient competition. It should not pursue a goal of competitive affirmative action in which entrants are protected from competition by the ILECs to make up for the head start ILECs have as incumbents. The existing ILEC networks are productive assets and it is efficient for society to use them if the marginal cost of using them is less than the cost of investing in new networks to replace them. Also, the FCC has no inherent interest in the label proliferation that might arise as competitors use ILEC networks to offer local service and exchange access under their own names. From the standpoint of economically sound public policy, these points should be completely self-evident. However, the presence of competitors will create the appearance of competition and will thereby vindicate Congressional passage of the 1996 Act and the FCC's implementation of it. Regardless of appearances, however, inefficient competition will ultimately impose a burden on consumers in the form of higher prices and higher universal service subsidies.

III. THE NATURE OF THE "MARKET-BASED" APPROACH

A. An Alternative Perspective

Labels can be deceiving, so it is important to consider the FCC's market-based approach without the label. In Phase 1, pricing flexibility (quantity and term discounts, geographically deaveraged rates, discounts for demand growth and, most generally, customer-specific contracts) are granted once unbundled elements are available at geographically deaveraged forward-looking economic cost and ILECs meet a variety of other conditions that facilitate

local exchange competition and that are mandated by the 1996 Act. In Phase 2, some easing of price cap regulation is to be provided once an interconnection agreement is reached or, possibly, once potential competition has existed for a suitable period of time. In Phase 3, once enough competition exists that the ILEC can be said no longer to have market power, price caps for exchange access are to be lifted altogether.

To be sure, the term “market based” approach can be justified on the grounds that competition provides the direct constraint on the price of exchange access. At the same time, however, it is important to note that price regulation is not eliminated even at Phase 3. Rather, regulations on the price of exchange access services are replaced by regulations on the price of inputs to the provision of exchange access. Thus, the protection provided to consumers under this approach is that if the ILEC charges an excessive price for exchange access, competitors will be able to assemble the exchange access from unbundled elements. This approach can be contrasted with the “prescriptive approach,” which entails the direct regulation of access prices.

B. Relative Advantages of Regulating Input (Unbundled Element) vs. Output (Service) Prices in General

In the NPRM, the FCC seeks comments on when its “market based” (input price regulation) approach would be preferred and when a “prescriptive approach” (service price regulation) is better.⁸ Each has advantages and disadvantages. A major advantage of regulating input prices is that it requires less information. To determine the cost of services,

⁸ NPRM, ¶ 18.

regulators must know the cost of inputs as well as the production function for turning the inputs into services. This last type of information is not needed if input prices are regulated.

A related advantage of regulating input prices arises if there is uncertainty about the efficient form of service prices. For example, if the appropriate mix of fixed and usage sensitive fees is not known, then regulating input prices allows the providers some flexibility in setting the form of output prices.

One factor to consider is the relative number of elements and services. If a small number of inputs is used to provide a large number of services, then regulating the price of inputs is, all else equal, simpler.

A final factor to consider is the relative amount of joint and common costs at the different levels. If, in fact, the entire cost of a loop can be identified and loops are used to provide local and exchange access service jointly, then regulating the service prices requires an arbitrary allocation whereas regulating the input prices does not. On the other hand, if elements are used in fixed proportions to provide a single service and there are costs that are either truly joint or otherwise difficult to allocate, it is easier to regulate the price of the service.

C. Reservations about the Market-Based Approach in Access Reform

Once the nature of the “market-based” approach is understood, the natural question that arises is why the Phase I conditions are not sufficient for the elimination of price caps altogether on exchange access. The rationale for making unbundled elements available is to

create as close to a perfectly contestable market as possible.⁹ One reason for not eliminating price caps once unbundled elements are available is skepticism about the validity of contestability theory.¹⁰

At a more practical level, the answer lies in a peculiar feature of the exchange access market. The direct purchaser of access is an end-user's IXC. For switched access, however, the provider of at least some portion of exchange access is determined by the end user. As a result, competition will take the form of competing for end users rather than offering discounts directly to the purchaser of access. For this competition to work, either IXCs will have to purchase unbundled elements (or invest in facilities) to provide local service or enter into a joint marketing agreement with a competitive local exchange carrier (CLEC). Moreover, for this competition to work effectively, IXCs must be allowed to pass the price of access charged by an end user's LEC directly to the customer rather than averaging access charges over the entire country or even a service area. The FCC should eliminate any regulatory barriers that prevent IXCs from passing on access charges.

⁹ See William J. Baumol, John C. Panzar, and Robert D. Willig, *Contestable Markets and the Theory of Industry Structure*, rev. ed. (New York: Harcourt Brace Jovanovich), 1988.

¹⁰ At a theoretical level, a market is only perfectly contestable if there are literally no sunk costs, a condition which plainly would not be met; and there is some controversy as to whether very low levels of sunk costs make the market nearly competitive. See Joseph E. Stiglitz, "Technological Change, Sunk Costs, and Competition," *Micro-Brookings Papers on Economic Activity*, 1988, pp. 883-947. At an empirical level, the predictions of contestability theory have not been borne out in some industries where the underlying conditions of contestability seemed to apply.

D. Safeguards

If the FCC does not have confidence that competition from purchasers of unbundled elements will restrain access pricing, it might consider alternative safeguards. The most logical alternative is to reset price caps for access on a geographically deaveraged basis. The only practical alternatives are to enter into cost of service proceedings, which would be slow and costly, or simply to pick a percentage by which existing price caps would be relaxed based on a sensible estimate of the variation in costs across zones. In deciding what geographically deaveraged prices to allow, the FCC should consider that while inefficiency results from prices being too high, imposing prices that are too low creates inefficiencies as well. Because of its concern with the consequences for income distribution, it should not necessarily treat the costs symmetrically. It should recognize, however, the basic economic principle that excessively low prices can result in shortages both by providing insufficient incentives to invest and by encouraging excessive use by those who place relatively low value on the service.

IV. ADVANTAGES OF PRICING FLEXIBILITY

The FCC has proposed conditions on the granting of immediate pricing flexibility. To understand the cost of denying pricing flexibility, it is important to consider the benefits that pricing flexibility provides. The advantage of geographic deaveraging was discussed above. This section focuses on the need for contracting flexibility to meet competition and the general benefits of contracting flexibility.

A. General Presumption that Contracting Parties Should be Allowed Mutually Agreeable Terms

Exchange access is an intermediate input sold by local exchange companies to providers of long distance telephone service. Regulations on access pricing prevent excessive pricing of this input and thereby provide protection to IXC's. A general issue in regulation is whether the parties must accept the precise contract mandated by regulation or whether they should be allowed to substitute a mutually agreed-upon alternative. There should be a strong presumption that any such alternative is in the public interest. An IXC and a provider of exchange access are partners in the provision of long-distance telephone service, and their mutual interest is to provide that service efficiently. Thus, as is discussed above, the need for geographic deaveraging is obvious as a matter of basic economics. As is discussed below, the need to allow ILECs the same contracting flexibility as their facilities-based competitors is also obvious. The need for other forms of pricing flexibility might be less obvious, but the burden of proof should be to show why pricing flexibility should not be allowed rather than why it is needed.

B. Need for Immediate and General Pricing Flexibility to Meet Competition

Wherever facilities-based competition exists or is possible, as is the case for special access and switched access dedicated transport, the ILECs must be able to respond on a contract basis. Competitors can choose which customers to supply and which links between end offices and IXC POPs to provide. The downward pricing flexibility that the Commission has granted is not sufficient to ensure efficient competitive outcomes. Requiring the ILECs to